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SUPPLEMENTARY FINANCING: THE PROPOSALS AND THE ISSUES†

I. THE RATIONALE OF SUPPLEMENTARY FINANCING

Supplementary financing refers to the use of economic assistance to reduce the damage caused to less developed economies by unpredictability of export proceeds. The rationale for supplementary financing is that the damage to economic growth from shortfalls in export earnings allegedly exceeds the benefit to economic growth from export surpluses. Most less developed countries have only limited scope for adding new productive projects to their development plans. Consequently an unforeseen increase in export proceeds cannot be fully invested until the next planning period. When foreign exchange earnings fall below the anticipated level, some projects must be scrapped. It may be difficult to replace these projects by others with lower foreign exchange requirements. As a result, deviations in foreign exchange receipts from the anticipated level are likely to result in a reduced rate of growth.

It is useful to make a conceptual distinction between instability and unpredictability of export proceeds. The former can be dealt with by compensatory finance, the latter by supplementary finance. If fluctuations around the trend are considered damaging, the problem is to identify these fluctuations and to reduce them. This may raise practical and statistical difficulties, but no serious theoretical problems.[1]

The meaning of the term supplementary finance has been evolving and changing in response to new rounds of international negotiations, mainly because the definition of the problem is itself shifting through time. A parallel situation can be found in the lack of clear-cut views on the problem of long-run deterioration of the terms of trade, as compared to the relative simplicity of the short-term instability issue. Thus, unless it is argued that short-term export instability may be good for development, its elimination or attenuation will at

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[1] For a review of proposals on compensatory financing see (*4*). For an elaboration of the criteria behind a compensatory financing mechanism see (*5*).

worst cause no damage, and at best substantially increase efficiency and prospects for growth. A truly compensatory financing scheme can be inherently costless. By definition, short-term instability is evidenced by fluctuations around a trend; negative deviations are offset by positive deviations, and no net cost results from elimination of the instability, except for the costs of administering the scheme.

Correction of a long-term trend in aggregate export earnings is a more doubtful proposition. It could reasonably be argued that offsetting long-run terms of trade declines will prevent the country from moving towards a more advantageous allocation of resources and towards diversification, and, to that extent, will contribute to perpetuating underdevelopment. This argument is valid, however, only if there is a readiness on the part of the international community to assist the efforts of the developing countries to achieve the transition towards a more modern and diversified economic structure.

The underlying rationale for supplementary financing is the alleged responsibility of the international community to ensure that the developing countries' efforts at transition are not frustrated by severe, uncontrollable, and unexpected shortages of foreign exchange. The first basic difference between supplementary finance and compensatory financing mechanisms lies therefore in the emphasis given by the former to "reasonable expectations" of export earnings, rather than to statistically defined export deviations from a trend. Expectations are by definition centered on the future, while deviations from trends are based on past export patterns. While compensatory financing aims at reducing instability, supplementary financing is intended to reduce unpredictability.

Unless it is thought that expectations of export earnings coincide with statistically defined trends, one ought to look at the planning process as the most likely embodiment of the country's projected exports. Supplementary finance implies a clear and direct link with development planning, a link which is clearly outside the scope of the more automatic compensatory finance.

The third distinguishing characteristic of supplementary finance is its residuality. Even if well-functioning commodity agreements were in force for major commodities, shortfalls from export expectations would still occur. Even perfect smoothing out of short-term fluctuations would do nothing to eliminate the disruptive consequences of unexpected export shortfalls which could not be dealt with by short-term balance of payments support. Insofar as commodity agreements and other *ex ante* measures are not adequate to eliminate the divergence between expected and actual exports, and insofar as compensatory financing is not designed to deal with shortfalls from expectations, a supplementary (residual) financial mechanism is needed.[2]

Compensatory financing ideally leaves the trend alone and offsets only short-term fluctuations, while some supplementary financing solutions contribute to attenuating longer-term export declines. While a compensatory scheme involves little or no net and cumulative transfer over time to the recipient countries, a supplementary financing scheme represents a net addition to existing aid programs.

[2] Excessive emphasis on supplementary finance as a residual mechanism can, however, be dangerous. The implication may be that the non-residual, more fundamental mechanisms of international assistance for development are really quite complete and adequate, and do not need much expansion or readjustment, which is not a very accurate picture of the current state of affairs in development aid.

There are also political-institutional differences between compensatory and supplementary financing. Supplementary finance will most probably be under the aegis of the World Bank, while compensatory financing is administered by the IMF.[3] This seemingly unimportant consideration has had a considerable influence on the progress of international negotiations on supplementary finance, as we shall discuss later.

Perhaps the strongest point in favor of the supplementary financing notion consists of the stimulus it may provide to effective development planning. Existence of a financial incentive directly related to the seriousness of the country's efforts and administered at the international level is likely to have a strong effect on the coordination and effectiveness of domestic efforts at development.

II. THE PROPOSALS

The principal characteristics of supplementary financing—residuality and emphasis on reasonable expectations—are embodied in the 1964 recommendation of the first UNCTAD,[4] the relevant passages of which are quoted below:

> . . . *the Conference recommends* . . .
>
> The new Scheme should aim to deal with problems arising from adverse movements in export proceeds which prove to be of a nature or duration which cannot adequately be dealt with by short-term balance of payments support [residuality]. Its purpose should be to provide longer-term assistance to developing countries which would help them to avoid disruption of their development programs [link to development planning]. . . .
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> . . . assistance should be on concessional and flexible terms [transfer element]. . . .
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> The Scheme should normally be applicable after a developing country had had recourse to the International Monetary Fund under its compensatory financing facility [residuality]. . . .
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> . . . .
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> An adverse movement for the purposes of the Scheme should be regarded as a shortfall from reasonable expectations . . . of the level of export proceeds [reasonable expectations]. . . .
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> . . . .
>
> Resources for the Scheme, which would be administered under the International Development Association [institutional element], should be in the form of additional commitments [additionality of resources] . . . .

The major alternatives in response to the UNCTAD Recommendation are discussed below.

1. *The Development Insurance Fund Scheme*

The forerunner in the supplementary finance field was the Development Insurance Fund scheme, presented in 1961 by a committee of experts appointed by

[3] For details on the IMF compensatory financing facility, which has been in operation since 1963, see (*3*).

[4] Recommendation A.IV.18, adopted (with 106 votes to none, with 10 abstentions) by the first UNCTAD in June 1964.

the United Nations (7).[5] Although developed at a time when compensatory financing was the only term available on the market, the D.I.F. scheme is related to supplementary financing since it involves a net and cumulative transfer of financial resources to the countries whose exports are being stabilized, and contributes to offsetting longer-term export declines.[6]

The D.I.F. scheme, essentially the brainchild of Albert G. Hart, is basically a social insurance fund with continuing annual premiums. According to the original proposal, contributions are made in proportion to the country's share of world exports and share of world national income. Fluctuations are computed as the difference between present year's exports and the average of the previous three years. Compensation for downward fluctuations is made in the form of grants and contingent loans, the latter repayable if the trend of the recipient country improves (i.e., if exports rise above the average of the preceding 3 years). Compensation is made only for fluctuations above 5% of exports and is limited to 50% of the excess over this minimum percentage.

2. *The World Bank Scheme*

UNCTAD recommendation A.IV.18 called on the World Bank to study the feasibility of a supplementary financing scheme, and, if appropriate, to elaborate such a scheme. In December 1965 the World Bank presented a staff study on the subject (2), which concluded that the problem of the disruption of development plans caused by shortfalls from reasonable expectations of export proceeds was indeed a serious one, and that the international setup provided no adequate mechanism to deal with this problem.

The study also elaborated in some detail on a scheme of supplementary finance, which became the object of three years of international discussion which is still continuing. The scheme, following the UNCTAD recommendation, is designed to offset, or attenuate, the alleged disruptive effect of unexpected export shortfalls on the development plan. The World Bank scheme has therefore the distinction of being the first major proposal designed to deal with one particular aspect of the problem of export unpredictability and to tailor the amount and conditions of financing to the situation of each country, rather than simply aiming at stabilizing aggregate exports without taking into consideration the varied effects of instability on different countries. This distinction is both an advantage and a liability. Dealing with one aspect of the question is an advantage insofar as this feature minimizes side effects and reduces the possible inefficiencies of a rigid aggregate mechanism. On the other hand, it is a serious liability because, as we shall see, as one steps down from the relatively simple world of aggregate stabilization on a standard basis, things become exceedingly complex and any concrete scheme is open to criticism.

Starting from the basic objective, i.e., preventing or attenuating the disruption of development plans caused by shortfalls from reasonable export expecta-

[5] The Committee consisted of: I. H. Abdel-Rahman, Antonio Carrillo Flores, John G. Crawford, Albert G. Hart, S. Posthuma, and M. L. Qureshi.

[6] The United Nations Working Group appointed to evaluate the proposal stated explicitly that: "the DIF scheme would do something to help offset persistent downward trends in export proceeds" (7).

tions, the Bank study sets out a number of general premises (2, pp. 6–7). First, uncertainty is unavoidable in all economic matters, and particularly in the development planning process. A major cause of uncertainty is unforeseen adverse changes in export earnings. Second, external assistance to assure a smooth growth process will contribute to the development and diversification of exports, which are the only long-run solutions to the problems of instability and of slow export growth of developing countries. Third, foreseeable declines in export earnings call for long-term financial assistance, and do not fall within the confines of the uncertainty problem which the Scheme is designed to deal with. Fourth, investment decisions are partly based on reasonable expectations of export proceeds, and shortfalls from such expectations expose development programs to disruption. Fifth, prior agreement between developing countries and the agency administering the scheme (hereinafter referred to as "the Agency") on "sound development programs and policies" makes it possible to combine certainty and speed of assistance "with assurance to the donor countries and the Agency regarding the efficient utilization of domestic and external resources" (2, p. 7).

From these basic premises follow all the specific features of the Bank scheme. The best definition of reasonable export expectations, in the context of development planning, is the export projections on which the plan is based. Thus, shortfalls from reasonable expectations are defined, in the Bank scheme, as shortfalls from the country's export projections for a medium-term plan (4–6 years) and not as deviations from a statistical-historical trend. The projections would be revised during the period only if a revision of the plan itself were called for. The scheme does not, however, spell out the circumstances under which revision of the overall plan, and thus of the export projections, would be in order.

Since the objective of the scheme is to ensure the level of export earnings on which the plan is based, upward deviations from the export projections (overages) are to be used for offsetting shortfalls. Supplementary finance is therefore provided only for the *net* shortfall over the plan period, i.e., for the difference between total export shortfalls and total export overages. Net overages are not, however, carried over from one period to the next. At the end of the projection period, the net amount of supplementary finance provided is transferred into long-term indebtedness, the terms and conditions of which are intended to be suited to the debt-servicing capacity of the country.

Clearly, some mechanism is needed within the scheme to prevent countries from drawing up unrealistic or exaggerated projections of exports in the hope of increasing their future claims on the Agency, and to prevent them from following unsound policies. Export expectations would be agreed to in the form of precise projections, the duration of which should be synchronized with that of the development plan of the country. The policy package would include agreement between the country and the Agency on the financing plan for public investment (and on estimates of private investment) and on the balance of payments projections (including estimates on the use of reserves and of the availability of various types of external financing). In order to keep the policy package flexible and responsive to changes which might occur during the plan period, periodic consultations are also provided for, at the initiative of either the country or the Agency. The policy package, therefore, serves two main purposes in the

Bank scheme. First, it provides a basis for making a distinction between shortfalls from reasonable expectations and shortfalls from unreasonable or willfully exaggerated expectations. The reasonability is pragmatically defined *ex ante* representing the outcome of the exchange of views and reconciliation of estimates between the country and the Agency. Second, the policy package attempts to ensure that the country's incentive to export is not impaired by the existence of supplementary finance, by providing for *ex ante* agreement—and *ex post* evaluation—by the Agency with regard to the country's domestic and external policy measures.[7]

The scheme also has to take into account the fact that planning is meaningless in those developing countries which lack the necessary informational and technical base. Since, as we shall discuss later, this is a crucial point in the feasibility of the Bank scheme, it is worth quoting the Bank study *in extenso*:

> Many developing countries have not yet arrived at the stage when a comprehensive planning process becomes desirable or feasible. They do not have the statistical base, the administrative framework, or the political desire or cohesion to formulate development policy on an economy-wide basis. In these cases, the process could start initially in the specific part of the economy which satisfies the prerequisites for systematic policy formulation: for example, a partial public investment action plan could be combined with projections of likely developments in the private sector. In all cases it would be essential and should be possible to agree on specific financing plans and balance of payments projections for the period, in addition to agreement on the policies needed to implement these plans. It would be in keeping with the intent of the UNCTAD resolution [A.IV.18], if the Agency would adopt a flexible interpretation of the criteria of potential disruption in those cases where it believed that development programming was as systematic and comprehensive as objective circumstances allowed or made desirable (2, pp. 10–11).

Agreement on the projections and on the policy package would ensure that the recipient country would receive speedy and adequate assistance from the Agency in the event of a shortfall. It would also provide an assurance to the contributing countries that their funds were being used in a manner consistent with the objective of the scheme.

The Bank carried out a simulation exercise on the operation of the proposed scheme and estimated the total gross shortfall between projections and actual exports to be $1.6 billion per year during 1959–63 (2, pp. 61–72 and Annex IX). After correcting for the use of overages within the projection periods and for IMF drawings under the compensatory financing facility, the overall estimate is reduced to about $1.2 billion per year. Taking into consideration other elements such as improved projections, incentives for sound domestic policy, availability of other foreign exchange resources, and internal policy adjustments, the study concludes that, during an initial period of five years, the scheme could function

[7] The reader is reminded that the Bank scheme acts on aggregate export earnings, and is not intended to exert any influence on the incomes of individual producers within a country. Thus, it would not affect the incentives of individual producers to expand production and exports or to move out of an unprofitable activity, as the case may be.

with about $300–$400 million per year.[8] It is also contemplated that, should the estimate prove to be on the low side, some mechanism for rationing of funds could be introduced in the scheme.

The scheme assumes that the funds needed would not be subtracted from the flow of aid. If recipient countries could not count on a net increase in aid, they would have no reason to submit to the policy requirements of the scheme, and if they did not submit, the rationale of the proposal would be voided. If only some countries were to enjoy a net benefit one would risk destroying the cohesion of the group of developing countries' for questionable benefits to only a few countries.[9]

Clearly, it is relevant to ask whether supplementary finance is an efficient form of aid, especially if the financial additionality assumption should prove to be unrealistic. The main difference between traditional forms of aid and aid channeled through a supplementary finance agency is that the allocation of the latter is left mainly to the recipient governments. In addition, under a semi-automatic scheme of the IBRD type, the donor has little control over the timing and the size of the aid. The political feasibility of different forms of aid should also be taken into account, for efficient forms of aid might be politically less acceptable. The dislike of many donor country legislatures for untied aid is a case in point. It is also reasonable to argue that, owing to the high time preference and high cost of waiting in many less developed countries, these countries are not in a position to keep adequate reserves, and therefore need an international mechanism through which last-resort funds can be made available.

The World Bank scheme was the subject of extensive international discussion at an Inter-Governmental Group on Supplementary Financing[10] (hereinafter referred to as "the Group"). Because of the dissatisfaction of several countries with various aspects of the scheme, a number of alternatives were suggested.

3. *The French Proposal*

The first alternative, proposed by the French delegation in the Group, represents a complete rejection of the very idea of supplementary finance. The French contention is that such a scheme deals only with the effects of export instability rather than with the causes of both instability and unpredictability of export earnings. It was pointed out that a supplementary finance scheme might be able to offset an unexpected export earnings decline, but would not assist in neutralizing a shortfall which could be forecast in advance, thus penalizing countries which made better projections. The French also raised doubts about the advisability of using supplementary finance to enable less developed countries to push through their plans regardless of what happened to export earnings, and questioned the Bank scheme's emphasis on export declines as a major cause of disruption of development plans.

[8] This estimate has been criticized for being rather on the low side. The reader interested in the estimation procedure is referred to (2, Annex IX).

[9] Despite considerable differences in the views and interests of different developing countries, they have managed to act somewhat as a unit at the first and second UNCTAD conferences, and to preserve to some extent the cohesion of their group (the so-called Group of 77).

[10] The Group, which was set up by the continuing machinery of UNCTAD, had a membership of 14 countries, and reported its findings in the final report to the second UNCTAD.

The French alternative consists of a system of "organization of markets" (*organisation des marchés*) for primary products. This would probably (the proposal has not so far been spelled out fully) mean creating a network of commodity agreements to cover most major export products of less developed countries. The model from which the French proposal appears to derive is the system of deficiency payments adopted at the urging of France by the European Economic Community vis-à-vis the Yaoundé Convention countries (the Francophone African countries). This system provides for payments to exporting countries when export prices for a number of vegetable oils fall below an agreed reference price. It therefore aims at stabilizing export revenue from these commodities at some predetermined level, rather than either reducing short-term fluctuations around an export trend (the objective of compensatory finance) or improving the predictability of aggregate export earnings (the objective of supplementary finance). Indeed, for the commodities covered, the deficiency payments mechanism is equivalent to eliminating an export trend altogether and rendering the market for these products inflexible downwards. Aside from the obvious loss in efficiency caused by interference of this type (a loss which could be quite tolerable if it were merely the cost of positive dynamic changes), carrying the argument to its logical conclusion would drastically reduce incentives to structural change and partially freeze the pattern of international specialization. This would also imply a permanent specialization of less developed countries in primary production. It is difficult to defend the political feasibility of the organization of markets proposal; one need only remind himself of the tremendous difficulty in reaching international agreement on even one major commodity such as cocoa, and of the recurrent problems with renewal of the existing commodity agreements—the case of coffee, for example.[11]

The French criticism does not appear to be valid. First, it could hardly be argued that a system predicated on the existence of a certain financial need discriminates against countries where (by virtue of more accurate projections of exports) the need for assistance is smaller. Second, the objective of the scheme is not to allow countries to push through with their plans no matter what happens to the external sector, but rather to prevent unforeseen export declines from disrupting otherwise well-conceived plans. Finally, although it might be said that the Bank scheme puts too much emphasis on unpredictability of export earnings, the latter is one cause of disruption of plans. An import constraint becomes much more severe if export forecasts turn out significantly wrong for reasons outside the country's control.

4. *The German Proposal*

The alternative proposed by the Federal Republic of Germany represents a rejection of the Bank scheme, although it may be interpreted to contain the spirit of the UNCTAD recommendation. The German Proposal does away completely with export projections as the basis for defining shortfalls from reasonable exports expectations. It substitutes for them a medium-term trend, defined as a two-year moving average of exports; shortfalls are thus calculated as the difference

[11] A sketchy description of the organization of markets proposal is contained in a memorandum submitted by France to the first UNCTAD conference (*8*).

between this year's exports and the average of the previous two years. Occurrence of a shortfall so defined would give rise to a *prima facie* case for supplementary financial assistance; the actual amount of finance given to the country would, however, be calculated also on the basis of other considerations, and could be greater or smaller than the size of the shortfall.

Among these considerations would be: the cause of the shortfall—presumably, a shortfall caused by ill-advised monetary, fiscal, or exchange policies would receive less consideration by the Agency than a shortfall truly outside the control of the country; the seriousness of the shortfall—presumably, only that portion which the country could not offset through recourse to ordinary and compensatory IMF drawings, through running down surplus reserves, or through cutting down on non-essential imports, would be compensable; the degree of possible disruption of the development program; the prospective development of exports; the applicant's general economic performance, and finally, "the financial resources available to the Agency" (*11*). The German Proposal, partly in the intent to lessen the jurisdictional dispute between the World Bank and the IMF, envisages a close connection between the scheme and the compensatory financing facility, and close cooperation between the Agency and the Fund, "possibly in a common body."[12] Unlike the World Bank scheme which, by relying on export projections as the basis for definition of shortfalls, is financially open-ended, the German Proposal envisages that the funds available to the Agency should be fixed in advance, and indeed lists the availability of financial resources as one of the considerations governing the amount to be provided in each case.

The advantage of the Proposal is that, by eliminating projections altogether, the need for a prior policy package is also obviated, simplifying the operation of the scheme considerably in comparison to that of the Bank scheme.

The German Proposal is, however, subject to some serious difficulties. The two principal objections concern the excessive discretionary nature of the scheme and the choice of a two-year export average as the basis for calculation of shortfalls. First, if such a large measure of discretion is allowed the Agency, no one can be reasonably certain that the actual operation of the scheme would serve the objective of recommendation A.IV.18, even though the degree of disruption of development plans is formally included as one of the considerations governing the amount of assistance; also, there would be almost complete uncertainty on the amount of assistance, whereas in the Bank scheme, if the country behaves, it has a reasonable assurance of getting at least the minimum of assistance necessary to stave off the worst of its export troubles. Second, it is very questionable whether a two-year export norm is in any sense an adequate definition of reasonable expectations. Such a norm would be so close to the standard used by the IMF in its compensatory financing facility as to render the German Proposal either an extension of compensatory financing or an intrusion into the area of competence of the IMF. Planning, if it is to constitute the basis for policy action, requires projections, not just moving averages of past years.

[12] In the Note originally presented by the Federal Republic of Germany at the second session of the Group (*10*) such common body would consist of a joint committee coordinating the supplementary finance agency and the IMF, which would examine the merits of each claim for assistance and decide whether the shortfall should be referred to the IMF compensatory financing facility or to the supplementary financing agency.

5. *The Refinancing Proposal*

A third alternative to the Bank scheme, advanced by the United States, originated in the Group and is still politically very much alive. This proposal consists of extending the IMF compensatory financing facility in those cases where repurchase of compensatory drawings would endanger the country's development efforts. Although it has come to be known as the "refinancing" alternative, the U.S. proposal would in fact do two things. First, it would consolidate IMF repurchase obligations into long-term debt in those cases where repurchase of compensatory drawings threatened disruption of development efforts (refinancing in the proper sense). Second, it would, where necessary for the integrity of the country's plan, provide drawings on terms similar to the IMF compensatory drawings when the country's compensatory entitlement (50% of quota) is lower than the export shortfall or when the country has already exhausted its entitlement. This may be called the "reconstitution" aspect of the U.S. proposal.

As in the case of the German Proposal, the U.S. alternative dispenses altogether with export projections and with the policy package, and relies on the IMF norm as the basis for calculation of shortfalls. Thus, the same objections brought against the German Proposal apply also in this case.

Other specific objections were made in the course of the discussion of the Group. First, the U.S. proposal is outside the terms of reference of the Group; the UNCTAD Conference made a specific recommendation for refinancing compensatory drawings. Second, the possibility of refinance is open even under the terms of the existing IMF facility. Third, and most relevant, if shortfalls are calculated on the basis of the IMF norm, there is practically nothing to refinance; according to the IMF itself, "96 per cent [of all shortfalls last] no more than three years" (*3*). Since repurchase of compensatory drawings is to be made in three to five years, it is obvious that refinancing proper would serve practically no function. Rather, the U.S. proposal may have a significant role in its "reconstitution" aspect (which for some reason has not received adequate attention during the Group's examination of the question). The function of the scheme would be to extend the IMF facility beyond the limit of 50% of quota and on a long-term basis in all cases where more than strictly short-term balance of payments assistance is called for. Although not as general a solution as the other alternatives, a scheme to reconstitute entitlements to IMF drawings and to lift the ceiling on the amount of compensatory finance might be of considerable help for some countries.[13]

III. THE INTERNATIONAL DEBATE ON THE WORLD BANK SCHEME

The UNCTAD Committee on Invisibles and Financing Related to Trade set up an Inter-Governmental Group on Supplementary Financing and mandated it to examine the overall feasibility of the Bank scheme. In the course of the discussion at the three sessions held by the Group (October 1966, February

[13] It is quite possible to imagine cases where a country has already exhausted its entitlement under the compensatory financing facility due to export shortfalls in previous years, and is left without any source of short-term assistance. It will be very interesting, for example, to see what happens to Ceylon's exports in 1969; Ceylon has already drawn from the IMF the maximum under its compensatory finance entitlement.

and November 1967), and at the second UNCTAD Conference (February–March 1968), a number of basic problems and several technical difficulties were raised. The basic issues may be clearer following a discussion of some technical points.

1. *Definition of Exports*

Questions arise whether statistics on services are reliable enough to permit inclusion of invisibles in the definition of exports, and whether the definition of exports should be adjusted according to changes in import prices. A qualified "no" should probably be given to both questions, in view of the complex statistical problems involved.

2. *Treatment of Overages*

The Bank scheme contemplates using overages within the projection period to offset shortfalls during the same period; overages may, however, be needed by the country for other purposes such as replenishment of excessively low reserves, anticipated financing of projects, servicing of foreign debt, etc.

3. *Terms of Assistance*

Recommendation A.IV.18 states that the terms of supplementary finance should be concessional and adjusted to the economic position of each country. There was criticism by some developing countries of the clause (*2*, p. 60) that under special circumstances the Agency could request advance repayment of loans. That clause seems, however, to be quite consistent with the objectives of the scheme and of the UNCTAD recommendation.

4. *Cost of the Scheme*

Some do not accept the Bank's contention that less than one-fourth of the estimated total shortfall would have to be financed under the scheme. The question arises as to whether it is possible to reach acceptable estimates of future cost on the basis of past export patterns. All estimates must, of course, be based on experience of the past; the changes in the pattern of exports from one period to another,[14] however, makes for considerable uncertainty. The Bank scheme explicitly contemplates the possibility of rationing of funds; but it is difficult to visualize how an equitable rationing mechanism could be evolved, given that claims for supplementary financial assistance would not come up for review all at the same time.

5. *Frequency of Revision of Export Projections*

Projected and actual exports will often diverge. The question arises of how to deal with changes in fundamental trends. It is very difficult to determine how often a country should revise its projections. On the one hand, it is in the interest of the country itself to respond to basic changes; on the other hand, too frequent revisions of the projections will result in treating a temporary deviation from expectations as a change in trend, thereby defeating the purposes of the scheme.

[14] A dramatic decrease in export instability from the period 1946–58 to the period 1954–66 took place, according to a recent study of the subject (*1*). Similar changes might occur in the future.

One solution would be to revise the export projections only when revisions of the plan itself are called for.

6. Relationship with the IMF Compensatory Financing Facility

The Bank scheme requires utilization of compensatory finance prior to the granting of supplementary assistance. Difficulties arise when the mechanics of residuality are examined. Some overlapping between supplementary and compensatory finance will be inevitable. The specifics of coordination between the Bank scheme and the compensatory financing facility are therefore important.

The Group spent a great deal of time discussing the above and other technical points. While these are relevant to the operation of the scheme, reasonable solutions might be found relatively easily. However, there are serious disagreements on the essential features of the Bank scheme. The major objections are the following.

(1) *Uncertainty over the use of export projections.*—Many developed countries are very reluctant to commit themselves to a system of financial assistance based on what they believe to be unreliable guesses. Even in an advanced country, accurate projections of exports for a period of five or six years cannot be made; thus, there is a very strong sentiment that export projections drawn up on the basis of inadequate data and the shifting economic situations of developing countries cannot possibly form the basis of financial commitments and claims. The real objection is not the cost of the scheme as such, but rather accepting a commitment the magnitude of which cannot be known in advance. Nor would incorporation of a rationing mechanism be of great help, for developed countries would still have to bind themselves to a system which logically requires theoretically unlimited assistance. One does not have to go along completely with the open-endedness objection in order to understand the force of it.[15] Thus, one has been witnessing what may be interpreted as well-intentioned attempts on the part of some developed countries to come up with alternatives that are more definable financially.[16]

(2) *The policy package.*—Although consistent with the logic of the Bank scheme, the idea of the policy package unquestionably raises enormous difficulties. There is, first, the staggering magnitude of the administrative task of reaching agreement on the plans and policies of 60 or 70 developing countries, and of policing the agreement. Second, there is a serious question as to whether this kind of policy scrutiny for so many countries and on a continuing basis could be effective enough to satisfy even the minimum objectives of the scheme. Third, the notion of a policy package agreed to and supervised under the aegis of the World Bank is in direct conflict with the IMF's view of the international financial system, and specifically with the authority the IMF now derives from being the sole residual source of international finance. The Bank scheme may undercut the influence of the Fund in international financial affairs. Aside from the pos-

[15] Especially if one visualizes the political difficulties which executive departments of developed countries would have in trying to justify a commitment of this nature to their parliamentary committees.

[16] A less charitable interpretation would view the presentation of those alternatives as attempts to stall supplementary finance to death.

sible decrease of the IMF influence on domestic policies, the policy package notion is the principal reason for the opposition of the IMF from the beginning. This, in turn, weakens the political acceptability of the scheme. Fourth, many developing countries (particularly the Latin-American countries) are unhappy at the prospect of being subject to additional infringements on their economic sovereignty.

(3) *Additionality of resources.*—An agreement on supplementary finance would not be financed entirely at the expense of other forms of aid. However, it might result in only a modest net increase in aid. For this reason, developing countries whose exports are more predictable have less to gain and more to lose from a supplementary financing scheme, and are consequently unenthusiastic about reaching an agreement.

Among the members of the Group, many developed countries are generally favorable to the concept of supplementary finance. Of these, the U.K. and Sweden (sponsors of the original UNCTAD recommendation) have been solidly in support of the Bank scheme, although the U.K. has recently tended to adopt a more ambivalent attitude. France has consistently opposed the notion of supplementary finance and the Bank scheme in particular. Germany and Japan, while ostensibly not unfavorable to the principle, have voiced doubts about the Bank scheme, particularly on the open-endedness issue. The attitude of the U.S. has gradually changed from a non-committal one in 1966 to one of strong doubts in the latter half of 1967 and at the present time. In 1967 and the first two months of 1968 the question of replenishment of the resources of the International Development Association entered international discussions and supplementary financing lost priority among both developed and developing countries. Governments of developing countries, mainly the Latin-American countries, have increased their support for the Bank scheme. The IMF has been consistently and logically opposed, while the World Bank and the UNCTAD secretariat have supported the Bank scheme.[17] In early 1967 the outlook for international agreement at the Second UNCTAD on at least the fundamentals of the Bank scheme was favorable. However, after taking note of the disagreements that had emerged throughout the work of the Group, the second UNCTAD conference referred the entire matter back to the Group, suitably expanded, and passed a resolution merely reaffirming the objective of recommendation A.IV.18.[18] For all practical

[17] It must be noted, however, that the scheme was never purported "to represent the views of the Executive Directors of the Bank, or of their governments which appointed or elected them" (see letter of George D. Woods, President of the World Bank, to U Thant, transmitting the Bank staff study (2)). Also, with the accession of Robert McNamara to the Presidency of the World Bank, the views and attitudes of this institution on the matter of supplementary financing and on the scheme elaborated by its own staff are for the moment unclear.

[18] After the second UNCTAD conference, the Group held its fourth session from 21 to 25 October 1968. It was decided not to discuss the main issues at that time, but to look at the question of what additional information the Group would need in order to analyze the substantive issues and take a firm position on the matter in the course of the next (the fifth) session. The Group requested that the secretariat of UNCTAD, or the staff of the World Bank or of the IMF, examine several complex topics, such as: the relationship between the IMF compensatory financing facility and the supplementary finance proposals; the relationship between domestic adjustment measures, export shortfalls, and the financial assistance needed; the extent to which the Bank scheme could be implemented within the existing institutional framework of the World Bank and of the IDA; and estimation of the cost of the scheme. In general, the discussion at this last brief session of the Group seemed to show a somewhat more favorable attitude to a form of supplementary financial assistance. The Group is now slightly more weighted towards the developing countries. One has a strong impression that substantive

purposes, therefore, the matter is right back to the initial 1964 position, and the Bank scheme is barely being kept alive.

IV. A "CONTINGENCY" VERSION OF THE BANK SCHEME

Failure to reach agreement on supplementary financing is due to objections to specific features of the Bank scheme. The difficulties which have been encountered arise, in the author's view, from two characteristics of the Bank scheme:

1. The scheme is too rigid to permit minor modification. The scheme does not seem suited to the day-to-day realities of international public finance.
2. The scheme provides a link between the export pattern and the amount and timing of the supplementary finance provided, but no link between the export pattern and the amount and timing of repayment. This causes much of the uncertainty over the use of projections, and the relatively high cost of the scheme.

The following proposal tries to bring the scheme as close as possible to the views expressed by some developed countries, while maintaining its residuality and at least a potential structural link with development planning.

"Contingent" Long-Term Nature of Supplementary Finance Loans

The very notion of shortfalls implies by definition that of overages. Just as the supplementary financial flow to the country is related to the occurrence and size of a shortfall, overages should logically generate a reverse flow. This would obviously be politically unacceptable. What may be feasible, however, is to make the timing of repayments of loans dependent on the occurrence and size of an export overage. The Bank scheme does apply overages to offset shortfalls in the same plan period. The scheme, however, does not carry over net overages of one plan period to the next: "The net deficit over the entire projection period that was financed by the Agency would be transferred into long-term indebtedness. However, net overages would not be transferred from the accounts of one projection period to the next" (*2*, p. 11).

Each projection period is independent, and projections of foreign exchange earnings are a function of export prospects, not a function of past foreign exchange availabilities. Were the net overage to be carried over *into the future,* this would have the effect of practically nullifying the scheme. A shortfall from reasonable expectations, which are not based on past net overages, would have to be financed from past net overages nevertheless. The Bank scheme envisages that a stronger balance of payments position would be taken into account when assessing the need for basic aid (*2*, p. 42).

One can introduce a modification which would relate net overages *to the past* operation of the supplementary finance mechanism. This variant has its origins in the characteristics of two previous schemes: the Development Insurance Fund proposal and the Periodical Restitution proposal.[19] The former envisaged compensation partly in the form of contingent loans; i.e., loans to be repaid only if the export trend improved. The latter called for the net compensation received

decisions will emerge at the next session of the Group (to be held in June 1969), and that some specific agreement will result although certainly not along the lines of the Bank scheme.

[19] See (*7*) and (*5*). On related considerations see (*3*) and (*11*).

by the country over one period to be restituted to the Agency over the next period. Combination of these two notions consists of the following. The long-term loans resulting from consolidation of net shortfalls would in all cases contain an advance repayment clause. According to this clause the loan is repayable in advance if a net overage should appear in any future period. The proportion to be repaid would be related to the size of the net overage. The long-term character of the loan is thus contingent on non-occurrence of a net overage in future projection periods. The proportion to be repaid should of course be less than the net overage, and should possibly bear a relation to the debt-servicing capacity of the country. This would presumably also be considered in the long-term loan agreement at the time of drafting. The specifics of the advance repayment clause would probably be different for different member countries.[20]

Introducing this modification would reduce, probably considerably, the cost of the scheme.[21] After a few years, advance repayments would start coming in and could be used for new loans. Thus, the Agency could give the same degree of protection against unpredictable export shortfalls with less money since it could rely on advance repayment of a certain proportion of outstanding loans. The extent of savings would depend on the frequency and size of net shortfalls; these can be expected to be similar to the frequency and size of net overages. (This is shown, *inter alia,* by the IBRD simulation exercise (*2,* p. 96) which yielded cumulative aggregate overages somewhat in excess of cumulative aggregate shortfalls in 1950–63.)

"Contingent" Use of Export Projections

It will be recalled that the use of export projections for calculating shortfalls led the Bank study to introduce the controversial and cumbersome policy package, to ensure that the projections are reliable and that the country pursues sound policies. The policy package is intended as an *ex ante* measure: "The establishment of what are reasonable export expectations would involve an investigation of the facts and policies of individual member countries, and would be undertaken at the beginning of the plan period, not at the time of difficulties" (*2,* p. 30).

The *ex ante* nature of the "investigation of the facts and policies" is partly due to the necessity to ensure promptness of assistance for qualifying countries. But, besides being cumbersome, the *ex ante* policy package raises doubts on the part of the recipient countries, who would have to submit to this kind of policy scrutiny before knowing whether they need supplementary financial assistance. One cannot get around this problem by calculating shortfalls on the basis of an automatic norm. As we have seen, a strong point in favor of supplementary finance is that it would operate towards improving the planning process. To calculate shortfalls solely on the basis of projections is unacceptable or cumbersome, since it implies the need for policy surveillance. To calculate shortfalls solely on the basis of export norms would defeat the purpose of supplementary finance.

[20] The Bank scheme does take into account the possibility of advance repayment; however, it either leaves the option to the member governments (*2,* p. 11) or contemplates the possibility in exceptional circumstances (*2,* p. 60).

[21] It is not possible to try to quantify the savings involved, owing to the unavailability of data on individual countries' projections.

The solution suggested here is to give to the Agency the authority to determine *ex post* whether to use the country's own projections or an automatic norm as the basis for calculation. The need for promptness of aid could be filled by interim financing, the amount of which would be left to the discretion of the Agency after consultations with the country and the IMF. The lower limit to the size of the loan would be in relation to the shortfall calculated on the basis of the norm, and the upper limit in relation to the shortfall calculated on the basis of the country projections. The residuality of the scheme would be maintained. Whether the Agency accepted the country's projections, used an automatic norm, or took an intermediate position, only that portion of the shortfall which could not be absorbed by the country without endangering its development plan would be compensable.

To make the use of export projections fully contingent on the Agency's favorable *ex post* assessment of the reasonableness of the projections and of the soundness of the country's policies would not eliminate the open-endedness of the scheme. The scheme would still be open-ended upwards. However, the commitment of developed countries would be limited by compensation on the basis of the norm. Additional finance would be a bonus for countries making a more serious effort. The international commitment of developed countries would be no greater than under the refinancing alternative, although their contribution would be larger. The burden of making the scheme operate to prevent disruption of development plans would be shifted to the developing countries themselves. The latter would have sole responsibility for evolving reasonable projections, following sound policies, and exhausting other sources of funds before applying to the residual lender, realizing that approval is at the discretion of the Agency.

It was pointed out earlier that one of the drawbacks of the Bank scheme is its lack of flexibility. The Bank study states: "On balance, therefore, the Agency should decide the question whether a particular country qualifies for assistance in terms of Yes or No, rather than in the form of How Much" (2, p. 66).

The modification suggested here introduces the possibility of "Yes But" and a whole range of finance and definitions of shortfall tailored to each country. This increased flexibility should allow a more realistic treatment of countries where planning is either non-existent or rudimentary. When viewed together with the elimination of the policy package and with the savings resulting from the advance repayment clause, this change may significantly increase the acceptability of the scheme.

Some General Considerations

To some extent, these changes in the scheme would reduce the incentive of some developing countries to participate. However, these are likely to be the countries least in need of the scheme. The country itself decides whether or not to apply for supplementary finance. The country alone makes its projections and determines policies; therefore few *ex ante* obligations exist. The Agency has authority to scrutinize plans and policies only if the country applies for supplementary finance. Any reduction of the benefits of the scheme for developing countries would be more than offset by the greater acceptability of the revised package for the developed countries. The scheme with the above changes would lie somewhere between the original scheme and the German and refinancing proposals. The two main modifications suggested here—the application of future net overages to advance repayment, and the discretionary power of the Agency to apply the norm or the country projections—are independent of one another, and could be introduced separately.

A Summary

A summary of the operation of the scheme follows. (Unspecified details remain as outlined in the original version of the Bank scheme.) The country would draw up its own projections, with technical assistance by the Agency (if desired). The projections would be registered with the Agency, which would also keep a record of export norms of the IMF type. Upon receiving an application for supplementary finance, the Agency would provide some interim financing, pending an examination of the country's projections and policy response. The amount of interim financing would depend on the Agency's judgment (*prima facie*) of what is strictly necessary, reached through consultations with the country and with the IMF. At the end of the projection period, all entitlements would be recalculated and revised, on the basis of the Agency's judgment. Compensation would range from the IMF norm, as lower limit, to the export projections, as upper limit. Should the net shortfall be greater than the aggregate amount of interim financing, the difference would be loaned, and the total funds provided consolidated into long-term debt. Should the net shortfall be lower than the aggregate amount of interim financing already provided, the difference would be repaid to the Agency within the next projection period. The long-term loan agreement resulting from consolidation of compensation from net shortfalls would in all cases contain an advance repayment clause, whereby a certain proportion—possibly as high as 50 per cent—of net overages in any subsequent projection period would be used to repay outstanding supplementary finance indebtedness. To prevent the sudden occurrence of repayment obligations, some pay-as-you-go mechanism could be devised, similar to a payroll deductions system. The Agency would be empowered to waive the advance repayment clause in exceptional cases.

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